Kazakhstan's Economic Prospects and Challenges[1]
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Kazakhstan is a vast and sparsely populated middle-income country with an economy that relies heavily on mineral extraction. Following the achievement of independence from the dissolving Soviet Union in 1991, it went through a period of severe economic adjustment. Then in the early 1990s Kazakhstan undertook a series of reforms that ranked it as a leader among former Soviet republics. It then entered into a period of rapid economic growth that drew mainly on its ample petroleum resources. From 2000 to 2004, the country received substantial foreign investment, raised oil production by 15% a year and benefited from high world oil prices. Its rate of economic growth averaged over 10% a year and per capita income more than doubled. Some of the receipts from petroleum exports were prudently deposited in a national oil fund.

One of Kazakhstan's attractions for foreign investors has been its political stability. Nursultan Nazabayev has been president continuously since 1991 and was reelected to a new seven-year term in 2005 in an election that the Organization for Security and Cooperation in Europe said fell short of international standards. The Economist Intelligence Unit (EIU) expects Nazarbayev to stay in office at least for the remainder his term, but speculates that he will have to work harder than before to ensure that tensions among the elite and the impact of the recession do not weaken his control.

The global recession has negatively affected Kazakhstan, largely through the oil and financial markets. Although real GDP grew by 8.5% in 2007, the tightening of world financial markets beginning in August 2007 made it increasingly difficult for local banks to raise external funding. Credit growth halted abruptly and the property bubble collapsed. The rise in oil prices during the first half of 2008 cushioned the impact of this halt in capital inflow for a while, but when oil and commodity prices fell sharply later in the year and global financial markets froze up, Kazakhstan was hard-hit.

Kazakhstan's financial and balance of payments positions have deteriorated substantially. The central bank devalued the tenge, the local currency, by 20% in February 2008. Sharply falling oil and commodity prices, combined with the freezing up of global financial markets, led to a contraction of GDP in the first quarter of 2009. Regional spillovers, particularly from Russia, aggravated the situation. Despite a contraction of imports in response to the devaluation, the current account moved back into deficit in early 2009 as exports slumped. The foreign currency holdings of the national oil fund fell sharply as funds were disbursed under the anti-crisis plan. Reserves in this fund stood at $23 billion in October 2009.

As a result of these unfavorable developments, the IMF determined in October 2009 that the situation in the banking sector had deteriorated significantly and that risks and uncertainties were high. The slowing economy and exchange rate devaluation added to the pressures on the banks. Non-performing loans have risen rapidly, reaching 34.7% of the total

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outstanding by the end of September. Questions grew about the value of the external assets of some of the banks, especially assets held in Russia. Capital adequacy came under pressure and several banks faced solvency issues. The government is attempting to deal with weakness in the banking sector, especially two large banks (BTA and Alliance) whose debt may need to be restructured. It has created a state entity, Samruk-Kaznya, which is intended to play a major role in helping Kazakhstan weather the economic crisis.

Against this background, the IMF and EIU expected the economy to contract by 2% in 2009 then grow modestly, perhaps by 2%, in 2010. (The government, however, forecast 1% growth in 2009.) While the economy could now be picking up, the Fund believes that Kazakhstan is still exposed to significant downside risks. Severely negative consequences could develop if the world economy fails to recover and oil prices decline. These circumstances could trigger a loss of confidence in the banking system and the currency, leading to a run on deposits and capital flight. The squeeze on bank balance sheets in such a scenario would be the epicenter of an economic crisis, spreading through the economy largely via credit channels.

To counter these risks, the government has instituted strong measures to support the banking system and the real economy. These include a $10 billion anti-crisis spending plan, tax cuts for firms in non-extractive sectors and substantial liquidity injections by the central bank. Fortunately, the government has large fiscal resources that could be used to provide further stimulus in 2010 if needed.

Corruption is widespread in Kazakhstan and serves as an impediment to business operations and growth. This makes the country a less attractive place to invest than some of the other transition economies. Yet Kazakhstan ranked a relatively favorable 63th out of 183 countries in the Ease of Doing Business index published by the World Bank in its *Doing Business 2010.* Two problem areas within the business stand out in the latest ratings: trading across borders, in which Kazakhstan ranks 182nd in the world, and getting a construction permit, a category in which it ranks 143rd (up from 177th in 2009). Strong areas in the World Bank rankings include registering property, enforcing contracts, employing workers and getting credit. Despite the limitations of its business environment, Kazakhstan remains an attractive investment destination, at least for extractive activities. FDI in the energy sector is still strong and bilateral financing deals totally $18 billion with China, South Korea, Russia, and the U.A.E. have recently been announced.

Oil and gas will remain the leading economic sector into the foreseeable future. Production of oil and gas condensate has risen since 2000 and industry analysts believe that planned expansion of oil production, together with the opening of the giant Kashagan field, will enable the country to double its current oil production level to as much as three million barrels per day by 2015. This would lift Kazakhstan into the ranks of the world's ten largest oil producers. In 2007 the government amended the Law on Subsoil and Subsoil Use to give itself the right to annul or amend contracts that it regarded as posing a danger to national economic security interests. The government insisted that it would not use the amendments retroactively to annul existing contracts.

Infrastructure is fairly well developed in Kazakhstan but the country lags in communication development and needs to improve its transportation, ports and pipelines. Infrastructure inherited from Soviet times now requires upgrading.

The government has a record of sound fiscal and monetary management. In 2000, Kazakhstan became the first former Soviet republic to repay all its debt to the IMF. Subsequently the country received high scores from international rating agencies. Kazakhstan has generally experienced moderate inflation, although in 2007 inflation peaked at 18.8%. The EIU believes inflation in 2009 was below the official expectation of 9%.

Life expectancy and other health indicators are poor, especially the life expectancy of men. Male life expectancy at birth is 67 years, versus 73 years for women. Government expenditures on health services are insufficient. Kazakhstan's population peaked at 16.5 million in 1990, and then declined because of falling birth rates, rising death rates and significant net emigration, especially of non-Kazakhs. These trends reversed after 2004 and the current population is reckoned at 15.6 million.

Literacy and school enrollment rates are high but skill shortages are severe. Enrollment in both primary and secondary school is mandatory. To a considerable extent, Kazakhstan's high enrollment numbers reflect the legacy of the Soviet system. Yet improvement in the quality of education is needed and many skills required by a modern economy are in short supply.

Diversification of its economy is a major development challenge for Kazakhstan. Its agriculture, consisting mainly of wheat and livestock production, is an important sector with vast areas of arable land but suffers from low productivity. Kazakh manufacturing is underdeveloped and will move ahead only when the business environment improves. The government plans to launch a five-year diversification plan in 2010.

Kazakhstan has enjoyed considerable success in poverty reduction. During the period of rapid growth in 2000-2004, the percentage of the population living below the national poverty line was cut in half, falling from 32% to 16%. The poverty rate in 2007 was 14%. Nevertheless, a significant number of citizens still live in crowded conditions and rural poverty is far higher than urban poverty. Regional disparities are marked.

The banking system is largely domestically owned but has relied heavily on foreign financing (Eurobonds and loans). About one-half of domestic deposits and credits are denominated in foreign currency. The top four banks account for 70% of bank assets.

External debt is high at close to 100% of GDP. However, about 40% of this debt is intra-company debt within the extractive sector.

Despite its current problems and possible medium-term perils, Kazakhstan's long-term prospects are favorable. The projected expansion of oil production, an abundance of other resources, responsible macroeconomic policy and other policy improvements set the stage for a promising future.

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